BRIEF IN SUPPORT OF THE PETITION.

Argument.

POINT I.

The Revenue Act of 1932 intended that no tax should be paid by appellee on the articles of jewelry sold by him to J. Mehrlust, Inc., before the effective date of the Act.

The tax imposed by Section 605 of the Revenue Act of 1932 applied only to sales by manufacturers, producers, and importers. Under the Act, there was a fifteen day interval from the time it became a law to its effective date within which manufacturers, producers, or importers of jewelry might dispose of articles already manufactured, produced, or imported by them free of excise tax liability. Thereafter when these same articles were sold no excise tax would be paid on such sales because they were not sales by the manufacturers, producers, or importers of such articles.

That the purpose of the fifteen day interval was to enable manufacturers, producers or importers to avoid the excise tax on the completed merchandise owned by them on June 6, 1932, is peculiary evident from the fact that the law did not provide for a floor tax. When the Agricultural Adjustment Act (Title 1, Public, No. 10, Seventy-third Congress) provided for a processing tax on certain articles thereafter to be processed, it likewise provided that such articles already processed should bear an equalizing tax called a floor tax. Likewise, when the Revenue Acts of 1918, 1934, and 1938, imposed increased taxes on the withdrawal of distilled spirits from bond, they imposed at the same time an equalizing floor tax on

distilled spirits already withdrawn. The purpose of floor taxes is to do equity between persons, and prevent them being placed in a position where they cannot equally compete with others in the same line of business. Excise taxes as heavy as the 10% tax imposed by Section 605 of the Revenue Act of 1932 of necessity add a most considerable burden to sales and unless some other relief is afforded, such as a tax operating only *in futuro*, a floor tax is necessary or a burden will fall more heavily on one competitor than another.

From the repeated imposition of floor taxes under various tax laws, it is most readily apparent that Congress recognizes the economic necessity for equality in competition and where necessary has attempted to bring this about. Therefore, when Congress failed to enact an equalizing floor tax in connection with the heavy tax imposed by Section 605, but instead provided a term of fifteen days before the effective date of the tax, thus enabling manufacturers, producers or importers to avoid such tax on their finished merchandise on hand by their sale, it is most apparent that they felt equalization was necessary and being accomplished by the fifteen day interval. As evidence that such was the intent and spirit of Congress, the following is quoted from the Report—Ways and Means Committee (72d Cong., 1st Sess., H. Rept. 708)—Title IV—Manufacturers' Excise Tax—Certainly as to Tax Liability:

> "Retroactive imposition of the tax, or change in the method by which the tax is computed, necessarily results in hardship and dissatisfaction, which in turn will bring about the break-down of the tax."

But equalization in the instant case could only be accomplished through the instrumentality of these fifteen

days if a sale before the effective date of the act to a wholly owned company could be recognized as an effective sale, so that no tax would be imposed on the seller when the articles sold were subsequently disposed of by the purchaser from him. Otherwise, the tax burden would fall most heavily on those who could least bear it. For a prosperous, well-organized company with an ultra-efficient sales organization could, within the fifteen days, escape tax by disposing of all its taxable articles to numerous customers. On the other hand, the struggling taxpayer who could not as well bear the burden of the tax because of his financial and business condition could not, because of his lack of a proper sales organization, dispose of taxable articles to the general market and thus avoid the tax as Congress intended. He could, however, readily dispose of such articles to a single customer, a wholly owned company not a manufacturer, producer or importer, and if such a sale is recognized, accomplish what Congress intended.

In this connection, it is pointed out that on June 6, 1932, there was finished jewelry for sale by retailers and wholesalers, and by manufacturers, producers, and importers. The jewelry being offered for sale by others than the manufacturers, producers, or importers could indisputably have been sold for a greater profit and yet for a less price than the articles then in the hands of the manufacturers, producers, or importers, if it were not for the fact that Congress granted fifteen days within which the manufacturer, producer or importer might sell his goods and place them on a price parity with wholesalers' and retailers' goods. The law did not limit the types of customers to whom the manufacturer, producer, or importer could sell. If, then, a manufacturer, producer, or importer sold to a single company, wholly owned by him, the goods he had on hand prior to the effective date of

the Act, he was merely accomplishing the intent of Congress and such sale should be recognized.

That it was the intent of Congress that a sale to a wholly owned company before the effective date of the Act should be recognized is further evidenced by the fact that there is no provision forbidding or covering such transactions, but with respect to such sale occurring after the effective date of the Act, Congress specifically provided in Section 619 (b) of the Revenue Act of 1932:

> "If an article is—
>
> (1) Sold at retail
>
> (2) sold on consignment; or
>
> (3) sold (otherwise than through an arm's-length transaction) at less than the fair market price; the tax under this title shall (if based on the price for which the article is sold) be computed on the price for which such articles are sold, in the ordinary course of trade, by manufacturers or producers thereof, as determined by the Commissioner."

Congress, as is evident from Section 619 (b), knew that sales would be made after the effective date of the Act to wholly owned companies. For purposes of the tax, Congress recognized such sales and provided for manufacturer's excise tax thereon. But it did not provide anything with respect to such sales occurring before the effective date of the Act, a most emphatic indication, especially when coupled with the future application of the law, that it intended that such sales might be made and tax avoided.

POINT II.

There is no general rule that the Treasury Department may in all cases, if it sees fit, disregard a corporation for the purpose of taxing its stockholder.

The Circuit Court of Appeals based its decision on *Higgins* v. *Smith*, 303 U. S. 473, *supra*. That case arose under the Revenue Act of 1932 and involved the right of a taxpayer to deduct, in determining his taxable income, a loss resulting from a sale of securities to a wholly owned company. The Court held that "the sale was ineffective to close a transaction for the determination of loss". The Court stated:

> "There is not enough of substance in such a sale finally to determine a loss."

But, *Higgins* v. *Smith*, *supra*, established no universal rule and certainly does not apply in the instant case. The income tax law contained no Section 619 (b) wherein Congress recognized the validity of sales between related identities and provided specifically with reference to the applicable tax base in the case of such sales to prevent tax avoidance. In this connection the following is quoted from the Report—Ways and Means Committee (72d Cong., 1st Sess., H. Rept. 708):

> "Third, provision is made for transactions in which, by reason of the relationship of the parties, the price charged does not represent a fair value arrived at by an arm's-length sale. For example, a manufacturer may transfer his product to a selling agency controlled by him, at a book-keeping price below market value. Or a manufacturing corporation may sell plant equipment to an affiliated concern at an arbitrary price. It is essential that in

such cases the tax be imposed on the same value as in the case of similar sales between independent parties."

In this connection also the following is quoted from a published ruling of the Treasury Department itself:

> "Section 619 (b) 3 is undoubtedly intended to prevent the avoidance of taxes which would easily be possible without its presence in the law. Congress apparently foresaw the probability of the creation of corporations having identical interests, one as the manufacturer and the other as the distributing agency, and sought to impose the tax on the full manufacturer's sales price where the manufacturing corporation sold to the distributing corporation at a nominal price. There are numerous other instances where similar mutual interests could operate to the disadvantage of the Government. Viewing the statute in this light, it must be presumed that Congress did not intend to have two or more affiliated corporations recognized as a single entity for manufacturers' excise tax purposes. If it had so intended it seems reasonable to believe that some provision would have been made in the statute for such recognition. That no such provision was made, coupled with the fact that transactions not at arm's-length are specifically provided for, leads to the conclusion that the intent was to impose a tax on all sales between such corporations." S. T. 617, XI-1 Cum. Bull. 513 (1932).

To repeat what was stated under Point I, Congress was fully alive to possible methods of escaping the excise tax by means of related taxpayers, and, nevertheless, recognized the validity of transactions between them. It chose to provide a means of preventing tax avoidance in the case of sales between related persons

after the effective date of the Act, but not on sales prior thereto. In view of a specific provision after the effective date and none before, coupled with the future application of the law and the equity behind such future application, it is most apparent that Congress did not intend the tax to apply under the facts in the present case.

This is peculiarly clear when it is considered that to sustain the Government's position it must be held that there was no valid sale by J. Mehrlust to J. Mehrlust, Inc., when, if the identical transaction had happened after the effective date of the law, by specific provision of the law (Sec. 619(b)) such a sale would be recognized and taxed. Surely if a sale were valid under the law if made after a specific date, the same sale was valid within the intent of the law when made before that date. Congress could never have intended that the whole nature of an act is different merely because it occurred before or after a point of time.

While is is true that the Court in *Higgins* v. *Smith* used language that considered alone might be construed to have wide application—

> "On the other hand, the Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purpose of the tax statute."

—yet such language was used by the Court in connection with a specific state of facts before it and should be considered in the light of those peculiar facts. As a

caution against construing the language of a decision too broadly, reference is made to the case of *Koshland* v. *Helvering,* 298 U. S. 441, where the Court said:

> "Although *Eisner* v. *Macomber* affected only the taxation of dividends declared in the same stock as that presently held by the taxpayer, the Treasury gave the decision a broader interpretation which Congress followed in the Act of 1921."

Moreover, in *Higgins* v. *Smith, supra,* when the Government contended for a certain application of *Gregory* v. *Helvering,* 293 U. S. 465, the Supreme Court said:

> "The Government urges that the principle underlying *Gregory* v. *Helvering* finds expression in the rule calling for a realistic approach to tax situations. As so broad and unchallenged a principle furnishes only a general direction, it is of little value in the solution of tax problems."

POINT III.

Because of the outside interests in J. Mehrlust, Inc., represented by the banks, the corporation was not one which the Treasury Department might disregard as it saw fit.

At the time of the formation of J. Mehrlust, Inc., petitioner owed the banks on his notes the large sum of $235,000. So far as the banks were concerned, their obligations were on a parity with all other liabilities of the appellee, and subject to all the risks of additional liabilities to which the individual might subject himself, and it was necessary that they keep themselves constantly advised as to his affairs, especially during the trying and uncertain times of 1931 and early 1932.

Therefore, from time to time, the banks questioned him as to the status of his affairs. However, by the formation of J. Mehrlust, Inc., and that company becoming primarily liable to the banks, the bank indebtedness was protected by the assets of the corporation and was relieved from the danger of present and future risks of individual liabilities. Following its incorporation, J. Mehrlust, Inc., was not in reality a corporation wholly owned by appellee, but a corporation in which there was a large outside participation, the participation of the banks, who had a first claim on its assets and whose rights could not be lawfully invaded or jeopardized by the appellee. As a consequence J. Mehrlust, Inc., was not one that could be disregarded because of its identity with its stockholder.

CONCLUSION.

In view of the wide spread effect of the principles involved and to resolve the doubts as to the correctness of the decision below, it is respectfully submitted that the writ of certiorari should be granted.

Respectfully submitted,

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